Future-Proofing the Board of Directors

To help navigate increasingly complex corporate governance challenges, a recent report by the National Association of Corporate Directors (NACD) Commission on The Future of the American Board highlights areas of focus for boards in 2023 and beyond.

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Boards have long navigated a complex business environment marked by technological change, business model disruption, activism threats, and regulatory pressures. The current environment also includes challenges of inflation and potential recession, rising geopolitical tensions, competition for talent and other scarce resources, and demands for greater transparency on the company's approach to climate change, cybersecurity, workforce diversity, and compensation. Intensifying political debate about the role of the corporation in society exacerbates these challenges.

Customers, investors, and employees are evaluating companies on product and service quality, financial performance, and employee satisfaction, as well as on their broader societal and environmental impact. Indeed, companies are viewed as more competent and ethical than government, according to the Edelman Trust Barometer (see 2023 Edelman Trust Barometer at 4). Yet, in the current polarized political sphere, companies also face criticism for being "woke" if they take a stand on matters beyond business operations and financial results.

In January 2022, the NACD convened experienced corporate directors, CEOs, investors, academics, and former regulators to consider the implications of this challenging environment for boards. In September 2022, the NACD Commission on The Future of the American Board released its findings and updated guidance in a report entitled "A Framework for Governing into the Future" (the Report).

This article discusses the Report's guidance and implications for boards in 2023 and beyond.

The Report

The Report acknowledges the many pressures facing companies and predicts that the challenges of board governance will only increase in complexity, with corporate governance becoming "more important in a world that at times seems ungovernable from a broader societal perspective" (Report at 10). Given corporate power and influence, companies "will continue to be looked to as allies for solutions to help build a better world, with success assessed through the lens of longer-term performance and societal impact, avoidance of unnecessary risk, and mitigation of negative external impacts" (Report at 9).

The Report also anticipates that companies and their boards will experience significant pushback. "In the face of broadening expectations, companies will increasingly find themselves at the center of contentious debates and criticized for taking — and for not taking — positions on a wide range of subjects, including some that may not directly relate to business operations." (Report at 10.) To position a company to respond appropriately to competing external pressures in a fast-paced and changing environment requires:

- A grounding focus on the company's purpose.
- An understanding of the company's key relationships and interests.
- An informed and agile board.

The Report sets out a framework of ten principles (the Framework) that boards of all types of organizations should consider for improving their agility and becoming "better stewards of long-term value creation for all stakeholders" (Report at 2). The principles are intended to assist boards in focusing on the nuanced and difficult issues of governance that are not amenable to checklists and best practice, "that are highly context dependent and to a large degree rely on the collective behaviors of individual directors" (Report at 11).

The Report also highlights key implications, relevant context, and implementation guidance, including critical questions for boards to consider.

The Framework

The Framework consists of the following principles:

- **Corporate purpose.** The company's purpose, as defined by the problems addressed and the needs filled by its goods and services, should drive its behavior, shape its governance, and position the company to create long-term, sustainable value.
- **Responsibility and accountability.** The board is responsible for the long-term, sustainable performance of the company. The board should design governance structures and practices that allow it to function effectively, efficiently, and with accountability.
- **Objectivity and oversight.** Governance structures and practices should position the board to provide objective judgment and active oversight supported by board leadership, which is separate from and independent of company management.
- **Agenda and information.** The board should design governance structures and practices that support it in determining board priorities, agendas, and information needs.
- **Board – management relations.** Governance structures and practices should support a relationship between the board and senior management that is open, objective, and both constructively supportive and challenging.
- **Strategy and risk.** Governance structures and practices should encourage the board to be adaptive and agile, focused on strategy and risk, and prepared to take appropriate action in a crisis.
- **Talent and compensation.** To succeed, the company requires a talented and motivated workforce. The board should focus on

corporate policies and practices that support the attraction, retention, development, compensation, and well-being of the company's workforce.

- **Corporate and board culture.** Both corporate and board culture should promote integrity, inclusion, and responsibility. Governance structures and practices should position the board to provide the appropriate oversight of company culture.
- **Composition, refreshment, and diversity.** The board should create governance structures and practices that ensure that directors are competent, committed, and diverse and that board and committee composition align with the company's changing needs.
- **Transparency, communications, and engagement.** The board should design transparent governance structures and practices that encourage communication and engagement with shareholders and other key stakeholders on matters of importance.

Corporate Purpose

The Report notes that corporations are created to develop, produce, and distribute goods and services that customers need or want.

The principle addressing the corporate purpose emphasizes that a company's purpose is defined by the problems or needs that the company's goods and services address. A company's purpose:

- Attracts and motivates employees.
- Drives innovation while focusing corporate activities.
- Guides boards and management in setting priorities and making strategic decisions.
- Provides discipline in resource allocation.

In carrying out its purpose (creating goods and services that customers need or want), a company can achieve profit. To make a profit, the company brings together the financial, human, and other resources to devote to its purpose, which, by solving a problem or filling a need, then benefits society. The company must simultaneously satisfy its customers and maintain beneficial relationships with employees, suppliers, regulators, and the communities in which the company operates. When a corporate purpose is well articulated, it becomes a powerful force for motivating and unifying corporate activity and setting priorities.

Responsibility and Accountability for Governance

Under state law, the board is responsible for the management and direction of the company and, to the extent it delegates management authority to others, it must oversee management. Directors are considered fiduciaries and are required to act in the company's best interests, which include the interests of shareholders. However, directors generally have discretion (outside of a sale-of-control transaction) to determine what is in the company's best interests and to consider the interests of stakeholders other than shareholders, as long as the decision is in general furtherance of corporate interests and long-term shareholder value.

Ultimately, the board must decide for itself how to carry out its responsibilities and design the governance structures and practices that best position it to fulfill its responsibilities effectively and efficiently. This principle recognizes the critical nature of board self-determination regarding governance and acknowledges that companies do not make profits in a vacuum. Contrary to the "anti-woke" movement, companies and boards cannot afford to neglect the interests of key constituents and the broader society.

The Framework emphasizes that shareholders have a special role to play in corporate governance. Among other rights that shareholders have, they elect directors and may also hold directors accountable through shareholder derivative suits, proxy contests, and negative (or withhold) vote campaigns. Boards should respect shareholder rights, setting policies that facilitate (rather than negate) them.

Objectivity and Oversight

While a board could theoretically manage a company, delegating day-to-day management to professional managers is more efficient. Additionally, this positions the board to be a distinct body that can bring additional perspective and objectivity through oversight. Oversight is the continual inquiry by directors into whether the board's delegation of authority to management is reasonable, and whether the information that management provides to the board can be relied on.

Objectivity is a matter of both board composition and board mindset. It requires directors who are independent, so that they are not likely to be conflicted or to be beholden to management, and who have both the capacity and the willingness to challenge management in constructive ways. Appointing a board leader who is independent of management and authorizing that leader to shape the board agenda and facilitate the flow of information from management to the board and to engage with shareholders and other stakeholders helps position the board to provide objective oversight and to act with agility.

Recent case law highlights the potential liability for directors, as well as attendant economic and reputational consequences for companies, when boards fail to oversee mission-critical risks. (See *In re Caremark Int'l Inc. Derivative Litig.,* 698 A.2d 959, 970-972 (Del. Ch. 1996); *In re Boeing Co. Derivative Litig.,* 2021 WL 4059934, at *26 (Del. Ch. Sept. 7, 2021)). Directors may be held liable for a failure of oversight under Caremark if the board either:

- Failed to implement any reporting or information system or controls.
- Having implemented a reporting or information system or controls, failed to monitor or oversee its operations, and so prevented itself from being informed of risks or problems requiring board attention. (*Stone ex rel. AmSouth Bancorporation v. Ritter,* 911 A.2d 362, 370 (Del. 2006).)

Shareholder-plaintiffs increasingly serve books and records demands on boards to further their *Caremark* claims of inadequate oversight of significant enterprise risks. Accordingly, it is important that boards ensure adequate information systems and internal controls are in place and actively monitor and oversee those systems and controls. (For more on *Caremark* claims and heightened scrutiny of the board's oversight role, see Board Oversight: Key Focus Areas for 2022 on Practical Law.)

Agendas and Information

The board is responsible for ensuring that it is positioned for informed, deliberative, and agile decision-making. It should determine its own priorities, which then allows the board to set its agendas and schedules. Additionally, as highlighted above, the board must work with management to ensure that the company has established information and reporting systems that will bring key information to the board's attention in a timely manner. To do so, the board and management should consider the type, format, and quantity of information that may be relevant and the time frame in which it is provided. To ensure that the board continues to have access to the right information, the board should periodically assess the information and reporting systems. However, the board is responsible for the careful review of the information that it receives.

The Framework recognizes that this complex and fast-changing world requires board agility, which in turn requires that the board:

- Have the capacity to address critical issues as they arise in a decisive and efficient, yet well-informed, manner.
- Be able to pivot when change is necessary.

Additionally, agility requires that directors devote time and effort to understanding the company, its industry, and the environment in which it operates. Directors need to keep themselves informed of changes in the company's operating environment that affect corporate strategy and risk, such as understanding how inflation and shifts in a geopolitical climate intersect with supply chain disruptions and resource scarcity.

While the role of the board has not changed, the context in which the board operates is in constant flux. In short, directors are expected to stay well-informed and be available on a frequent and flexible basis.

Board-Management Relations

The board needs to develop a clear understanding of and respect for the distinct roles of managing and overseeing. This requires a significant degree of trust between the board and management, and the development of a candid and constructive relationship in which the board both supports and challenges management.

Trust can be bolstered by:

- In-person interactions that reflect agreed on norms of behavior.
- Rules about access to directors and management during and between meetings, including time designated for the board to meet with individual members of management.
- Periodic training on board responsibilities.

The line between overseeing and managing is not fixed but changes with the circumstances. If directors overstep too much:

- Management becomes less responsible for performance, thereby degrading the oversight mechanism.
- CEO confidence becomes undermined, thereby breaking down trust and resulting in less candor.

Strategy and Risk

Strategy and risk require significant attention and should be the primary areas of board focus on an ongoing basis. The pace and scope of change requires that boards devote substantial time to monitoring strategic milestones and any market developments that may dictate adjustments to those milestones or to overall strategies, while staying up to date on:

- Risk, including the most critical risks the company faces, risks associated with corporate strategy, management's efforts at risk management, and the company's risk appetite.
- The environment in which the company operates, including understanding how environmental and social issues relate to the company's strategy, operations, risk profile, and relationships with key stakeholders.

Talent and Compensation

The Framework acknowledges that "[i]ncreasingly, employees seek personal meaning in their work and are attracted to companies that articulate a clear corporate purpose and culture, express values consistent with their own, and show respect for contributions to the team" (Report at 40).

Board attention to issues impacting the workforce requires keen awareness and should include an understanding of the link between strategic imperatives and officer and employee capabilities and constraints. The current tight labor market complicates companies' efforts to attract, develop, and retain a diverse and talented workforce.

Therefore, the board should place heightened attention on:

- Developing managers.
- Increasing employee satisfaction and engagement.
- Developing and supporting a positive and ethical corporate culture (see Corporate and Board Culture below).
- Overseeing corporate policies and practices that support the workforce, including a focus on:
  - diversity, equity, and inclusion (DEI);
  - fair compensation and benefits; and
  - employee health and safety.

These are vital to maintaining motivated employees to provide superior products, services, and customer experiences while reducing risk and compliance costs and productivity losses associated with workforce turnover.

Additionally, one of the most important responsibilities of the board is selecting the CEO. The board should ensure it develops and maintains policies and procedures for succession planning, setting CEO and executive compensation, and evaluating CEO and executive performance.

Corporate and Board Culture

A strong board and corporate culture is imperative for a company's success. The board must define and continually monitor the parameters of its desired culture. For example, agreed norms for director behavior can help in both preventing and addressing misconduct, bolstering trust, and establishing a strong board culture. (For more information, see Establishing Norms for Director Behavior to Enhance Board Culture and Effectiveness on Practical Law.)

Additionally, the board should hold management accountable for developing and maintaining a positive and ethical corporate culture. Corporate culture extends beyond the company and its treatment of employees to include interactions with suppliers, customers, and other stakeholders. As with board culture, the corporate culture should reflect integrity, candor, and trust, and the board should monitor information systems and controls to ensure that information relating to corporate culture, including whistleblower complaints, conflicts of interest, and breaches of compliance and ethics, can be reported up.

Composition, Refreshment, and Diversity

The board should regularly evaluate its composition to ensure that its makeup continues to serve the best interests of the company and its shareholders. For example, the board should:

- Frequently assess whether the directors have skill sets, experiences, and viewpoints relevant to the company's business.
- Evaluate whether the directors have the "soft skills," such as diplomacy, objectivity, candor, courage, and the ability to listen and work toward consensus, that are crucial for an effective board.
- Ensure that the board reflects diversity in tenure, gender, race, ethnicity, and age.
- Avoid defaulting to the re-nomination of directors rather than undertaking tough decisions.

Transparency, Communications, and Engagement

The board should value interactions with employees and other key stakeholders as opportunities to learn about their interests and concerns, and to build relationships of trust. However, the board must determine with management whether and under what circumstances to engage with stakeholders or the public on matters of importance to the company and its stakeholders, including political and social issues. The board should ensure that the company has clear policies about who is authorized to speak on behalf of the company.

Additionally, board-shareholder relations remain critical, especially given the increased concentration of ownership by institutional investors. It is becoming more common for institutional investors to support shareholder activist nominees in contested elections and to pressure companies on environmental and social issues. As fiduciaries, directors must be accountable to the best interests of the company and its shareholders, and the board should continually review the voting policies and priorities of major shareholders and proxy advisors, including recent voting practices.

New SEC rules require the use of a universal proxy card for director election contests. The adoption of these rules:

- Offers activists an easy and inexpensive way (that is, owning only one share for one minute is sufficient) to gain the attention of institutional investors by placing shareholder activist nominees on the same ballot as incumbent directors.
- Allows activists to nominate a slate of directors more easily.
- Permits shareholders to mix and match votes for company and activist nominees.
- Therefore, the board should prepare to face more:
- Single-issue activists on issues such as climate and DEI, in addition to economic activists.
- "Candidate contests," where shareholders choose preferred individual nominees.

(For more on the proxy rule amendments, see Considerations Regarding Universal Proxy in the January 2023 issue of *Practical Law* The Journal and see SEC Adopts Rules to Require Universal Proxy Cards in Contested Director Elections on Practical Law.)

Key Practical Takeaways

Companies are far more than economic engines. They are social constructs invented and given legal life because they benefit society through the goods and services that they provide. Fulfilling that expectation is their license to do business.

As the Report conveys, the long-term success of a company depends on a clear sense of purpose and delivering value that satisfies the fair interests of a range of key stakeholders. The board plays a distinct and critical role in this endeavor, and the Framework offers a set of principles for the board to follow in developing its governance structures and practices. Ultimately the board's success will determine whether a company has long-term, sustainable performance.

Articulate the Corporate Purpose and Adapt It to the Changing Environment

The board should consider:

- Whether the board is aligned with management on the articulation of the corporate purpose (as defined by the goods and services the company provides to address a societal need).
- Whether both the board and management look to the corporate purpose to help set priorities and guide corporate activity.
- How the corporate purpose and strategy are affected by the challenges of the changing environment, and what the board and management are doing to anticipate, adapt, and evolve.

Apply a Wide Lens for Accountability

The board should consider whether the board and management have reached a common understanding regarding:

- Decision-making authority and oversight roles, and whether that common understanding is evident in director behaviors.
- The key relationships that may be affected when exploring opportunities and risks, and whether the board and management actively consider those interests.

Maintain Board Focus on Strategy and Risk Mitigation Amid Economic and Geopolitical Uncertainty

The board should consider whether it:

- Understands:
  - the company strategy and related risks in the context of a potentially extended period of uncertainty;
  - how inflation and interest rates uniquely affect the company's business and industry; and
  - how the company is positioned to withstand shocks from system-wide risks, supply chain threats, and other sources of disruption and resource scarcity (for example, severe climate events, water, energy or mineral shortages, pandemic outbreaks, and cybersecurity threats).
- Has appropriate information and reporting systems in place to keep the board and management informed of issues impacting the long-term, sustainable performance of the company.
- Has a committee structure and an apportionment of responsibilities that adequately address oversight of mission-critical and other significant risks.
- Has appropriately mapped out how to address environmental, social, and governance (ESG) matters, human capital management, cybersecurity risks, and other key issues, including whether certain issues should be delegated to a committee or retained for the full board to consider and whether the board and its committees have access to appropriate expertise on these issues.

Apply Heightened Attention to Talent Management and Management Development

The board should consider whether it:

- Understands the competitive and other drivers impacting employee attraction and retention in the company's specific industry and how employee turnover impacts productivity and costs.
- Has visibility into:
  - employee satisfaction and the DEI culture at the company; and
  - the depth of the management bench and plans to develop future leaders.

Undertake a Critical Assessment of Board Composition

The board should consider whether:

- The board:
  - reflects a diverse set of backgrounds, expertise, and experiences;
  - has the appropriate skill sets and competencies to meet the challenges facing the company;
  - reflects a composition that is aligned with the company's needs in terms of strategic direction and mission-critical risks; and
  - avoids over-reliance on age or term limits at the expense of actively assessing board needs and director contributions.
- Each director:
  - fills a need;

- is prepared and available when needed to position the board for agility; and
- shares a commitment to a deliberative, collaborative culture and to abiding by the behavioral norms established by the group to help reach decisions efficiently in a fast-moving and uncertain environment.

Address Demands for Enhanced Transparency and Disclosure

The board should consider whether it:

- Is well-apprised of SEC and related developments that will shape future corporate disclosures.
- Understands the company's voluntary disclosures on ESG matters and the extent to which they comply with leading, private, market-led disclosure guidelines, such as those developed by the Global Reporting Initiative, the Sustainability Accounting Standards Board, and the Task Force on Climate-Related Financial Disclosures.
- Has an informed view of whether the company's disclosures meet the expectations of its key shareholders and stakeholders and, if not, in what respects and why.
- Has discussed how it will handle criticism relating to the company's political or social activities.

Enhance Shareholder Activism Preparedness and Defense

The board should consider whether it:

- Regularly engages with key shareholders and stakeholders, and understands their concerns and areas of interest.
- Has a team of executives and outside advisors (for example, legal, financial, and public relations advisors) prepared to guide the company in the event of an activist campaign.

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